SIDLEY AUSTIN LLP
ONE SOUTH DEARBORN
CHICAGO, IL 60603
+1 312 853 7000
+1 312 853 7036 FAX

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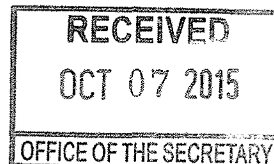

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From:

Name: Nissen, William J.
Voice: +1 312 853 7742

To:

Name: Mr. Brent Fields
Company: SEC
Facsimile#: 2027729324
Voice Phone:
Subject: OCC's Written Statement in Support of Approval Order, File No. SR-OCC-2015-02

Date: 10/7/2015 **Time:** 3:38:13 PM **No. Pages (Including Cover):** 34

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SIDLEY AUSTIN LLP
ONE SOUTH DEARBORN STREET
CHICAGO, IL 60603
+1 312 853 7000
+1 312 853 7036 FAX

wnissen@sidley.com
(312) 853 7742

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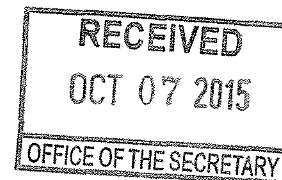

October 7, 2015

By Federal Express and Facsimile

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549-1090
Facsimile: 202-772-9324

Re: The Options Clearing Corporation's Written Statement in Support of Affirming March 6, 2015 Order Approving Capital Plan, File No. SR-OCC-2015-02

Dear Mr. Fields:

The Options Clearing Corporation ("OCC") hereby files the enclosed OCC's Written Statement in Support of Affirming March 6, 2015 Order Approving Capital Plan. The original and three copies are enclosed.

The enclosed OCC's Written Statement in Support of Affirming March 6, 2015 Order Approving Capital Plan has been served by Federal Express and facsimile on each party to the proceeding in accordance with 17 C.F.R. § 201.150, and as reflected in the Certificate of Service attached to it.

Very truly yours,

William J. Nissen

William J. Nissen

WJN:sn

Enclosures

cc: Division of Trading and Markets *(by facsimile 202-772-9273) (w/ encl.)*
Petitioners *(by Federal Express and facsimile) (w/ encl.)*

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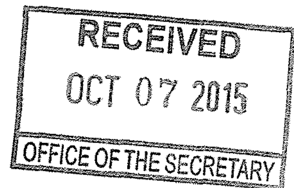

SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Petitions of The Options Clearing Corporation	)	**File No. SR-OCC-2015-02**

OCC's WRITTEN STATEMENT IN SUPPORT OF AFFIRMING MARCH 6, 2015 ORDER APPROVING CAPITAL PLAN

TABLE OF CONTENTS

Page

I. Introduction ... 1

II. Background ... 2

A. OCC Developed the Capital Plan After Thorough Deliberation ... 2

B. OCC Submitted a Proposed Rule Change Concerning the Capital Plan in Accordance with the Commission's Rules ... 5

C. Petitioners' Efforts to Delay the Capital Plan ... 7

III. The Commission Should Affirm the Approval Order Because the Capital Plan is Consistent With the Exchange Act ... 8

A. The Capital Plan Ensures That OCC Has Access to Necessary Capital ... 8

B. The Capital Plan Provides for the Equitable Allocation of Reasonable Dues, Fees, and Other Charges Among Its Participants ... 16

C. The Capital Plan Does Not Impose an Undue Burden on Competition ... 18

D. The Capital Plan Serves the Public Interest ... 24

IV. Conclusion ... 26

TABLE OF AUTHORITIES

Page(s)

Cases

Chamber of Commerce of U.S. v. S.E.C.,
412 F.3d 133 (D.C. Cir. 2005) 14

Nat'l Ass'n of Regulatory Util. Comm'rs v. F.C.C.,
733 F.2d 1095 (D.C. Cir. 1984) (per curiam) 13

Statutes

12 U.S.C. § 5465(e)(1) 5

15 U.S.C. § 78c(f) 18

15 U.S.C. § 78q-1(b)(3) 8, 16, 18

15 U.S.C. § 78s(b)(2)(C)(i) 8

15 U.S.C. § 78w(a)(2) 18

Other Authorities

17 C.F.R. § 201.411(b)(ii) 13

17 C.F.R. § 201.431(d) 1

17 C.F.R. § 240.19b-4(n)(1)(i) 5

5 U.S.C. § 706(2)(A) 13

Financial Stability Oversight Council 2012 Annual Report, Appendix A,
available at
http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf 3

Notice of Filing of an Advance Notice, Exchange Act Release No. 34-74202
(Feb. 4, 2015), 80 Fed. Reg. 7056 (Feb. 9, 2015) 5

Notice of No Objection to Advance Notice Filing, Exchange Act Release No. 34-74387 (Feb. 26, 2015), 80 Fed. Reg. 12215 (Mar. 6, 2015) 4, 6, 9, 17

Order Approving Proposed Rule Change Concerning a Proposed Capital Plan for Raising Additional Capital That Would Support the Options Clearing Corporation's Function as a Systemically Important Financial Market Utility, Exchange Act Release No. 34-74452 (Mar. 6, 2015), 80 Fed. Reg. 13058 (Mar. 12, 2015) .... *passim*

Order Discontinuing the Automatic Stay, Exchange Act Release No. 34-75886 (Sept. 10, 2015), 80 Fed. Reg. 55668 (Sept. 16, 2015)........ 7

Order Granting Petitions for Review and Scheduling Filing of Statements, Exchange Act Release No. 34-75885, 80 Fed. Reg. 557000 (Sept. 10, 2015) 1, 7

Staff Interpretation Regarding Consistency between Part 39 and The Principles for Financial Market Infrastructures, CFTC Memorandum No. 15-50 (Sept. 18, 2015) 5

Standards for Covered Clearing Agencies, Exchange Act Release No. 34-71699 (Mar. 12, 2014), 79 Fed. Reg. 29507 (May 22, 2014)........ 4

Pursuant to the Commission's September 10, 2015 Order Granting Petitions for Review and Scheduling Filing of Statements[1] and Rule of Practice 431(d),[2] The Options Clearing Corporation ("OCC") hereby submits this written statement in support of the March 6, 2015 order ("Approval Order") approving the proposed rule change concerning OCC's proposed capital plan ("Capital Plan").[3] The Petitions for Review ("Petitions") were filed by BATS Global Markets, Inc. ("BATS"), BOX Options Exchange LLC ("BOX"), KCG Holdings, Inc. ("KCG"), Miami International Securities Exchange, LLC ("MIAX"), and Susquehanna International Group, LLP ("SIG)" (collectively "Petitioners").

I. Introduction

The Commission should promptly affirm the Approval Order concerning OCC's Capital Plan because the Capital Plan is consistent with the Securities Exchange Act of 1934 ("Exchange Act") and would promote a compelling public interest by significantly strengthening OCC's capital structure for the benefit of the investing public. Ever since the Approval Order was issued, however, Petitioners have sought to delay the Capital Plan to promote their respective financial interests at the expense of the public good. For the reasons stated below, their arguments—many of which are based on incorrect and unfounded factual assertions—should be rejected by the Commission.

Time is of the essence. OCC respectfully requests that the Commission expeditiously conduct its review and affirm the Approval Order. OCC submitted an advance notice filing of the Capital Plan to the Commission on December 29, 2014 and, absent the objections of

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[1] Order Granting Petitions for Review and Scheduling Filing of Statements, Exchange Act Release No. 34-75885, 80 Fed. Reg. 557000 (Sept. 10, 2015) ("Review Order").
[2] 17 C.F.R. § 201.431(d).
[3] Order Approving Proposed Rule Change Concerning a Proposed Capital Plan for Raising Additional Capital That Would Support the Options Clearing Corporation's Function as a Systemically Important Financial Market Utility, Exchange Act Release No. 34-74452 (Mar. 6, 2015), 80 Fed. Reg. 13058 (Mar. 12, 2015) ("Approval Order").

Petitioners, it would have taken effect on March 6, 2015 upon issuance of the Approval Order. Now the substantial delay caused by Petitioners has jeopardized the Capital Plan. OCC's stockholder exchanges (collectively "Stockholder Exchanges") have contributed $150 million in capital contributions in anticipation of the Capital Plan's approval, but cannot be expected to allow their funds to remain with OCC indefinitely if uncertainty about the approval of the Capital Plan continues. If the Stockholder Exchanges were to withdraw their $150 million capital contribution, OCC's capital resources would have been less than $150 million as of August 31, 2015—less than half of the $364 million in capital resources available to it under the Capital Plan, and significantly less than the $247 million Target Capital Requirement. The Commission should not permit the Petitioners to use further delay to defeat the plan—which has already been pending with the Commission since last year—or to interfere with OCC's ability to meet existing and proposed capital standards and requirements. The Commission should promptly affirm the Approval Order before the end of 2015.

II. Background

OCC developed the Capital Plan after an extensive and detailed deliberative process. Following the Board's consideration of the Capital Plan's contours and impact, OCC submitted to the Commission a proposed rule to implement the Capital Plan under Section 19(b)(1) of the Exchange Act and an advance notice under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. At every opportunity thereafter, Petitioners have sought to delay implementation of the Capital Plan and derail OCC's efforts to achieve regulatory compliance and obtain the capital necessary to support its functions.

A. OCC Developed the Capital Plan After Thorough Deliberation

OCC developed its Capital Plan through a rigorous and systematic process in order to permit OCC to satisfy its obligations as a systemically important financial market utility

("SIFMU").[4] The Commission noted this extensive process in its February 26, 2015 Notice of No Objection to Advance Notice Filing:

- An outside consultant conducted a 'bottom-up' analysis of OCC's risks and quantified the appropriate amount of capital to be held against each risk, including consideration of credit, market, pension, operational, and business risk.
- Based on internal operational risk scenarios and loss modeling at or above the 99% confidence level, OCC's operational risk was quantified at $226 million and pension risk at $21 million, resulting in a total Target Capital Requirement of $247 million.
- Business risk was addressed by taking into consideration that OCC has the ability to potentially offset revenue volatility and possibly mitigate business risks by adjusting levels at which fees and refunds are set and by adopting a Business Risk Buffer of 25% when setting fees.
- Other risks, such as counterparty risk and on-balance sheet credit and market risk, were considered immaterial for purposes of requiring additional capital, based on means available to OCC to address those risks without use of OCC's capital.
- An analysis was performed to determine the greater of (a) the recovery or wind-down costs and (b) six months of operating expenses, resulting in the calculation of OCC's Baseline Capital Requirement at $117 million.
- The appropriate amount of a Target Capital Buffer was computed from operational risk, business risk, and pension risk, after taking into account the

[4] The Financial Stability Oversight Council designated OCC as a SIFMU on July 18, 2012. *See* Financial Stability Oversight Council 2012 Annual Report, Appendix A, *available at* http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf.

Baseline Capital Requirement of $117 million, resulting in a determination that the current Target Capital Buffer should be $130 million, which, when added to the Baseline Capital Requirement, resulted in a Target Capital Requirement of $247 million.[5]

In addition to the Target Capital Requirement, and in order to meet the requirement under proposed Commission Rule 17Ad-22(e)(15) ("Proposed Rule 17Ad-22(e)(15)") that OCC have a viable plan to replenish its capital in the event that it has general business losses causing its capital to fall below specified levels,[6] OCC's Capital Plan calls for the Stockholder Exchanges to make a commitment to provide replenishment capital, currently $117 million, which could be increased to as much as $200 million if the Baseline Capital Requirement increases ("Replenishment Capital Commitment"). The resulting capital resource requirements for OCC under the Capital Plan are $364 million.

OCC developed its Capital Plan to ensure that it was capitalized at a prudent level for a SIFMU, to meet existing international principles for central counterparties, and to proactively comply with proposed U.S. standards for central counterparties. Under the Capital Plan, as mentioned above, OCC will be prepared to comply with Proposed Rule 17Ad-22(e)(15). Moreover, the Capital Plan accounts for international standards, including the Principles for Financial Market Infrastructures ("PFMIs") Report published by CPSS-IOSCO and the Capital Requirements for Bank Exposures to Central Counterparties, also known as Basel III capital requirements, published by the Basel Committee on Banking Supervision.[7] Many of OCC's

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[5] Notice of No Objection to Advance Notice Filing, Exchange Act Release No. 34-74387, at 6-7 (Feb. 26, 2015), 80 Fed. Reg. 12215 (Mar. 6, 2015) ("Notice of No Objection").
[6] *See* Standards for Covered Clearing Agencies, Exchange Act Release No. 34-71699 (Mar. 12, 2014), 79 Fed. Reg. 29507 (May 22, 2014).
[7] *See id.*

clearing members are subject to international standards such as these, and OCC must remain current with them in order to serve as central counterparty for the international community and to prevent certain of its clearing members from being subject to onerous capital charges.[8] Moreover, OCC has 18 clearing members that are directly (or indirectly through affiliates) in this category, and which together represent approximately 25% of OCC's cleared options volume. If the Approval Order is reversed and the Capital Plan crippled, OCC may not be recognized as a qualifying central counterparty due to inadequate capitalization under the PFMI standards, and these clearing members would become subject to an estimated $30 billion in punitive capital charges. This negative consequence that could result from reversal of the Approval Order is significant, would be felt by the wider consolidated affiliates of direct members, and could result in grave international and domestic repercussions.

B. OCC Submitted a Proposed Rule Change Concerning the Capital Plan in Accordance with the Commission's Rules

Beginning in December 2014, after developing its Capital Plan, OCC submitted an advance notice filing[9] and a proposed rule change to enable it to implement the Capital Plan. Under the Capital Plan, the Stockholder Exchanges are required to (i) immediately contribute $150 million ($30 million each) in equity capital to OCC and (ii) enter into contractual agreements to ensure their Replenishment Capital Commitment up to an additional $200 million,

[8] OCC is also registered with the Commodity Futures Trading Commission ("CFTC") as a derivatives clearing organization ("DCO") for its futures clearing business. The CFTC Staff has interpreted CFTC regulations governing systemically important DCOs ("SIDCOs"), and those DCOs who elect to be regulated as SIDCOs, to be harmonized with the PFMIs. *See* Staff Interpretation Regarding Consistency between Part 39 and The Principles for Financial Market Infrastructures, CFTC Memorandum No. 15-50 (Sept. 18, 2015). OCC may be required to elect to be regulated as a SIDCO for its futures clearing business in order to be recognized under EMIR, and such election would make it subject to requirements consistent with the PFMIs as a matter of law.

[9] OCC filed the advance notice (File No. SR-OCC-2014-813) with the Commission on December 29, 2014 pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act, 12 U.S.C. § 5465(e)(1), and Rule 19b-4(n)(1)(i) under the Exchange Act, 17 C.F.R. § 240.19b-4(n)(1)(i). On January 14, 2015 OCC filed Amendment No. 1 to the advance notice in order to (i) update OCC's Capital Plan; (ii) correct typographical errors; and (iii) update the Term Sheet exhibit summarizing material features of the Capital Plan. *See* Notice of Filing of an Advance Notice, Exchange Act Release No. 34-74202, at 1 n.4 (Feb. 4, 2015), 80 Fed. Reg. 7056 (Feb. 9, 2015).

on a *pro rata* basis, to meet the requirement that OCC have a viable plan to replenish its capital in the event that OCC has general business losses causing its capital to fall below specified levels.

In order to provide a reasonable return to the Stockholder Exchanges for their substantial financial commitments, the Capital Plan includes the payment of dividends according to a formula that is designed to limit the amount of dividends paid to the Stockholder Exchanges and which would be subject to forfeiture in whole or in part in years in which additional capital is required. Accordingly, OCC's proposed rule includes a Fee Policy, Refund Policy, and Dividend Policy under which, absent extraordinary circumstances, fees will be adjusted periodically to cover OCC's projected operating expenses and to permit OCC to maintain a 25% Business Risk Buffer. To the extent that actual revenues exceed actual expenses at year-end, *and after funding any incremental increase in the Target Capital Requirement*, 50% of the excess will be refunded to the clearing members. After paying taxes on the remaining 50%, the after-tax amount will then be paid as dividends to the Stockholder Exchanges. To the extent that OCC's capital requirements increase over time, the increase may be addressed by both fee increases and earnings, thereby reducing funds available for both refunds and dividends.

On February 26, 2015, the Commission issued a Notice of No Objection to Advance Notice Filing, specifically finding:

> Given that OCC has been designated as a systemically important financial market utility, OCC's ability to provide its clearing services if it suffers business losses contributes to reducing systemic risks and supporting the stability of the broader financial system. In so doing, OCC's Capital Plan is consistent with the objectives of Section 805(b) of the Payment, Clearing and Settlement Supervision Act, which are to promote robust risk management, promote safety and soundness, reduce systemic risks, and support the stability of the broader financial system."[10]

[10] Notice of No Objection, at 25.

On March 6, 2015, the Commission, through delegated authority granted to staff of the Division of Trading and Markets ("Staff"), issued the Approval Order for the Capital Plan.[11] In the Approval Order, the Staff stated: "Given the critical role OCC plays in the U.S. options market and its designation as a systemically important financial market utility, the Commission believes it is both necessary and appropriate for OCC to obtain and retain sufficient capital to ensure its ongoing operations in the event of substantial business losses."

C. Petitioners' Efforts to Delay the Capital Plan

After being effective for only a week, however, the Approval Order was automatically stayed on March 13, 2015, when Petitioners filed Notices of Intention to Petition for Review, followed by their Petitions. OCC then moved to lift the stay to enable it to proceed with implementation of the Capital Plan. In granting OCC's motion on September 10, 2015, the Commission found:

> [I]t is in the public interest to lift the stay during the pendency of the Commission's review. Under the circumstances of this case, the Commission believes, on balance, that strengthening the capitalization of a systemically important clearing agency, such as OCC, is a compelling public interest. The Commission also believes that the concerns raised by the Petitioners regarding potential monetary and competitive harm do not currently justify maintaining the stay during the pendency of the Commission's review.[12]

Also on September 10, 2015, the Commission issued an order granting the Petitions, and permitting parties and other persons to file written statements in support of or in opposition to the Approval Order.[13] On September 15, 2015, Petitioners filed a "Motion to Reinstitute Automatic Stay," restating previous arguments contesting the merits of the Capital Plan. OCC filed a brief

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[11] *See* Approval Order.
[12] Order Discontinuing the Automatic Stay, Exchange Act Release No. 34-75886, at 2 (Sept. 10, 2015), 80 Fed. Reg. 55668 (Sept. 16, 2015).
[13] *See* Review Order, at 2.

in opposition to the motion, observing the procedural impropriety of the motion and identifying substantive deficiencies in Petitioners' arguments. The Commission has not ruled on Petitioners' motion to date. OCC submits this written statement is support of the Approval Order and, for the reasons stated below, respectfully requests that the Commission promptly affirm it.

III. The Commission Should Affirm the Approval Order Because the Capital Plan is Consistent With the Exchange Act

The Commission is required to approve a proposed rule change if it finds that the change is consistent with the various requirements of the Exchange Act.[14] The Staff, acting for the Commission by delegated authority, found that the proposed rule to establish the Capital Plan was consistent in all respects with the Exchange Act, satisfying this requirement. As explained below, none of the arguments that Petitioners or others have made provides any basis for the Commission to reverse the Staff's action in issuing the Approval Order. The Commission should affirm the Approval Order because it is consistent with the Exchange Act, as determined by the Staff in the Approval Order, and is critical to OCC's functions.

A. The Capital Plan Ensures That OCC Has Access to Necessary Capital

The Exchange Act requires that registered clearing agencies, including OCC, comply with standards, rules, and regulations applicable under the statute.[15] In approving the Capital Plan, the Approval Order specifically recognized that it is consistent with the Exchange Act's requirements that (i) "a registered clearing agency is so organized and has the capacity to be able to facilitate the prompt and accurate clearance and settlement of securities transactions, and to safeguard securities and funds in its custody or control, or for which it is responsible,"[16] and (ii) "the rules of a registered clearing agency [be] designed to promote the prompt and accurate

[14] 15 U.S.C. § 78s(b)(2)(C)(i).
[15] *Id.* § 78q-1(b)(3)(A)-(I).
[16] Approval Order, at 39 (citing 15 U.S.C. § 78q-1(b)(3)(A)).

clearance and settlement of securities transactions, and to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible."[17] The Approval Order recognized that without the Capital Plan, OCC would not be sufficiently capitalized to withstand adverse effects on its capital, putting clearing members' funds at risk.

Simply put, the Capital Plan is critical to OCC's functions as a SIFMU and its ability to comply with the Exchange Act. The Commission reviewed the Capital Plan in connection with OCC's advance notice filing and determined that the Capital Plan will achieve important protections for OCC and the broader financial system. In relevant part, the Commission specifically observed,

> The Capital Plan will provide OCC with an immediate injection of capital and future committed capital to help ensure that it can continue to provide its clearing services if it suffers business losses as a result of a decline in revenues or otherwise.[18]

The Commission rightly observed that the Capital Plan is necessary to allow OCC to address the challenges it faces and its current and future regulatory obligations. The Target Capital Requirement and Replenishment Capital Commitment included in the Capital Plan represent a prudent level of capital for a SIFMU now, irrespective of any future regulatory-imposed obligations. Indeed, if the Capital Plan is defeated, it is likely that OCC will be unable to achieve its total capital resource requirement of $364 million until mid-2017 under the current fee schedule in the absence of a significant increase in fees.

Not only is the Capital Plan critical to OCC's functions as a SIFMU and its ability to comply with the Exchange Act, its timely implementation is necessary to ensure OCC remains in

[17] Approval Order, at 39 (citing 15 U.S.C. § 78q-1(b)(3)(F)).
[18] Notice of No Objection, at 25.

compliance with evolving regulatory standards. Specifically, the Capital Plan would facilitate OCC's compliance with Proposed Rule 17Ad-22(e)(15) and Principle 15 of the PFMIs.[19] Although Proposed Rule 17Ad-22(e)(15) has not yet taken effect, OCC must take steps now to ensure compliance with it by the time it becomes effective, particularly given the unique ownership structure of OCC and the difficulty of quickly raising capital for an industry utility. The Capital Plan is thus essential to meet both OCC's present needs as a SIFMU and satisfy its evolving regulatory obligations as an international market actor.

OCC notes that many of those that submitted Comment Letters regarding the Capital Plan generally did not dispute the necessity of a capital infusion in the near-term, or the importance of adopting a longer-term capital plan to address the need for a source of replenishment capital.[20] Several Petitioners, however, make the unfounded assertion that the Target Capital Requirement in the Capital Plan is "inflated"[21] because it calls for ten times the amount of capital that OCC had during the 2008 financial crisis, and that OCC has enough capital without the Capital Plan. These arguments reflect either a lack of understanding or an intentional disregard of the many factors affecting OCC's capital needs, including both existing international principles and proposed domestic standards. Indeed, Petitioners' assertions at this stage of the Commission's

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[19] Proposed Rule 17Ad-22(e)(15) would require OCC to have liquid net assets funded by equity sufficient to cover potential general business losses so that OCC can continue operations and services as a going concern if those losses materialize. OCC's capital would be required in all cases to cover the greater of either (i) six months of OCC's current operating expenses, or (ii) the amount determined by the Board to be sufficient to ensure a recovery or orderly wind-down of critical operations and services of OCC, as contemplated by the Recovery and Wind-Down Plan that OCC will be required to create and maintain pursuant to Proposed Rule 17Ad-22(e)(3)(ii). OCC would further be required under Proposed Rule 17Ad-22(e)(15) to maintain a viable plan, approved by the Board and updated at least annually, for raising additional equity capital should its equity fall close to or below the amount required thereunder. The Capital Plan would also facilitate OCC's compliance with the international standards reflected in Principle 15 of the PFMIs, which requires that a central counterparty such as OCC have sufficient liquid net assets, funded by equity, to cover potential business losses that may occur at any time without prior warning.

[20] *See, e.g.*, Securities Industry and Financial Markets Association ("SIFMA") Comment Letter, at 2 (Feb. 20, 2015).

[21] BATS, BOX, KCG, MIAX, and SIG Memorandum in Support of Motion to Reinstitute Automatic Stay, File No. SR-OCC-2015-02, at 3 (Sept. 15, 2015) ("Petitioners' Memorandum in Support of Motion to Reinstitute Automatic Stay").

review are somewhat baffling given previous comments in which they expressed support for increased capitalization of OCC as a SIFMU.[22] Moreover, Petitioners' assertions should be rejected given the obvious inadequacy if OCC were to maintain only $25 million in equity capital—approximately 6 weeks of operating expenses—as the only SIFMU providing clearance and settlement services to the entire U.S. equity options markets. Petitioners' argument that the Target Capital Requirement is inflated should also be rejected because certain risks were not included in the Target Capital Requirement: namely, counterparty risk and on-balance sheet credit and market risk, based on means available to OCC to address those risks without using its capital. The Target Capital Requirement is based on a consideration and evaluation of specific risks, and is necessary to fulfill OCC's need for capital now, regardless of what level of capital was maintained by OCC seven years ago.

In addition to making the baseless assertion that OCC's Target Capital Requirement is inflated, Petitioners also contend that OCC has achieved, or is close to achieving, its Target Capital Requirement of $247 million. In so arguing, Petitioners completely ignore that OCC's current capital resource requirements under the Capital Plan are $364 million, *which includes the $117 million Replenishment Capital Commitment*. Petitioners' assessment that OCC has met its capital needs is based on speculation: Petitioners cite financial information showing OCC with $130 million in capital as of December 31, 2014 to produce an "estimate," without any valid basis, that OCC's capital will grow to "nearly $250 million" by the end of 2015.[23] Petitioners arrive at their "estimate" by including in capital the rebates owed by OCC to clearing members for 2014 and expected rebates to clearing members for 2015. But Petitioners ignore the fact that

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[22] *See, e.g.*, SIG Petition, File No. SR-OCC-2015-02, at 4 (Mar. 20, 2015) ("SIG Petition") ("We do not question the importance of OCC, its need to raise additional capital, or the benefits of a well-functioning clearance and settlement facility.").

[23] Petitioners' Memorandum in Support of Motion to Reinstitute Automatic Stay, at 4.

rebates to clearing members are not taxable because the rebates just return to the clearing members fees that they have themselves paid. If OCC were to retain these rebates as its own capital, it would be required to pay taxes on these amounts, and therefore Petitioners' "estimate"—which wholly ignores taxes—is invalid. In fact, as of August 31, 2015, if OCC had been deprived of the $150 million deposited by its stockholders as part of the Capital Plan, OCC's adjusted shareholders' equity would be approximately $149 million. OCC would also have no access to the Replenishment Capital Commitment of $117 million that is available to it under the Capital Plan. Thus, in the absence of the Capital Plan, OCC's capital resources would be less than $150 million, which is less than half of the $364 million in capital resources available to it under the Capital Plan, and significantly less than the $247 million Target Capital Requirement.

Several Petitioners also argue that the Capital Plan reflects an unacceptable departure from OCC's business model, noting that OCC has historically paid significant refunds to clearing members each year.[24] By adopting an approach that includes paying dividends to the Stockholder Exchanges that have made significant capital commitments, however, the Capital Plan allows OCC to reduce the historical pre-refund average Business Risk Buffer of 31% with a lower Business Risk Buffer of 25%. In addition, OCC will effectively refund 100% of the amount not required to be paid in dividends to the Stockholder Exchanges for their necessary initial and ongoing capital contributions and replenishment commitments.

Recognizing the weaknesses of their arguments against the approval of the Capital Plan, Petitioners have advanced a number of particularly specious arguments. Stated generally, Petitioners have suggested that the record was insufficient to support the Approval Order, and

[24] *See, e.g.*, BOX Petition for Review, File No. SR-OCC-2015-02, at 4 (Mar. 20, 2015) ("BOX Petition").

that the process by which the Capital Plan was developed and approved by OCC's Board suffered from a number of defects. None of these arguments, however, provides a valid basis for disapproving the Capital Plan.

Several Petitioners contend that the Approval Order is flawed because it embodies erroneous conclusions of material fact and law because the Staff did not, in their view, adequately describe the basis for its decision.[25] As a result, some contend that the Approval Order constituted an arbitrary or capricious action in violation of the Administrative Procedure Act.[26] Specifically, Petitioners argue that the Staff "failed to adequately analyze" aspects of the Capital Plan,[27] that it "erred in concluding that ... determining the cost of capital is subjective,"[28] and that it improperly failed to reference market studies.[29] As an initial matter, Commission rules do not require that its orders be supported to the extent and in the exact manner that parties might like. Instead, "[a]n agency decision arrived at through informal rulemaking must have a rational basis in the record and be based on a consideration of the relevant factors under its statutory mandate."[30] Indeed, in reviewing rules promulgated by the Commission, the D.C. Circuit Court of Appeals has expressly noted, "we are acutely aware than an agency need not—indeed cannot—base its every action upon empirical data; depending upon the nature of the problem, an agency may be entitled to conduct ... a general analysis based on informed

[25] *See, e.g.*, BATS Petition, File No. SR-OCC-2015-02, at 3-5 (Mar. 16, 2015) ("BATS Petition"); BOX Petition, at 2; MIAX Petition, File No. SR-OCC-2015-02, at 9-10 (Mar. 20, 2015) ("MIAX Petition"). According to Rule 411(b)(2)(ii), in determining whether to grant review, the Commission considers whether the Petition makes a "reasonable showing" that, among other things, "The decision embodies: (A) A finding or conclusion of material fact that is clearly erroneous; or (B) A conclusion of law that is erroneous; or (C) An exercise or decision of law or policy that is important and that the Commission should review." 17 C.F.R. § 201.411(b)(ii). The majority of Petitioners' and others' points, however, appear to be based on the assertion that the Capital Plan implicates an important matter of policy.
[26] 5 U.S.C. § 706(2)(A).
[27] BOX Petition, at 2.
[28] BATS Petition, at 10.
[29] BOX Petition, at 3.
[30] *Nat'l Ass'n of Regulatory Util. Comm'rs v. F.C.C.*, 733 F.2d 1095, 1124 (D.C. Cir. 1984) (per curiam).

conjecture."[31] Here, OCC's rule filing as submitted to the Commission on January 14, 2015 contained eighteen pages of detailed description and analysis, as well as the 131-page Form 19b-4. The Staff's findings followed 36 pages of description of the Capital Plan, OCC's position, and arguments advanced in seventeen comment letters. In approving the Capital Plan, the Staff grappled with a variety of perspectives and arrived at a conclusion reasonably based in analysis, relevant facts, and statutory considerations. Although Petitioners disagree with the Staff's conclusion, this alone does not render it arbitrary, capricious, or erroneous.

In addition, Petitioners argue that there was a defect in the approval process in that OCC should have considered alternative proposals, and that if it had, the Capital Plan would have been rejected. OCC, however, did consider numerous alternatives and rejected them for sound reasons. For example, BATS has argued that OCC should have allowed outside investment as part of the Capital Plan.[32] Such an argument wholly fails to appreciate that the Board examined the possibility of involving outside investors and determined in the course of its nearly year-long investigation into potential alternative capital plans that almost all of the alternatives examined—including using outside investors as sources of capital—posed significant tax, compliance, or governance and shareholder rights issues that made such alternatives uncertain, unsuitable, or unfeasible.

Some have argued that OCC should raise capital through the fee increases it imposed in 2014.[33] Fee increases, however, in addition to burdening the trading community, do not provide the immediate access to additional capital that the Replenishment Capital Commitment provides under the Capital Plan, and thus do not satisfy the requirement under Proposed Rule 17Ad-

[31] *Chamber of Commerce of U.S. v. S.E.C.*, 412 F.3d 133, 142 (D.C. Cir. 2005) (internal quotation omitted).
[32] *See* BATS Comment Letter, at 3 (Feb. 19, 2015).
[33] *See* Belvedere Trading, CTC Trading Group, IMC Financial Markets, Integral Derivatives, SIG, Wolverine Trading Comment Letter, at 6-7 (Feb. 20, 2015).

22(e)(15) that the clearing agency have "sufficient liquid net assets funded by equity." Further, in considering this alternative approach, OCC determined that under the current fee schedule, it would take until mid-2017 to organically accumulate $364 million in capital. As a result, OCC appropriately concluded that organic accumulation of capital through fee increases was not a durable solution to its substantial capital needs.

OCC's Board also considered whether viable alternatives to individual components of the Capital Plan existed. For example, OCC considered an alternative plan to limit the amount of time during which dividend payments are made to the Stockholder Exchanges, for example, by repaying the Stockholder Exchanges' capital contributions over a period of years. The Board rejected this alternative, however, because it would provide no assurance that it would comply with the requirement under Proposed Rule 17Ad-22(e)(15) that OCC's capital be "funded by equity." Furthermore, there would not be a sufficient financial incentive for the Stockholder Exchanges to provide short-term equity financing and replenishment capital to OCC on terms equal to those of the Replenishment Capital Commitment.

Petitioners have also suggested that the Capital Plan is invalid due to the manner in which it was approved by the Board. Petitioners have complained that Board representatives of the Stockholder Exchanges did not recuse themselves from relevant discussions or the Board's vote approving the Capital Plan.[34] This argument simply ignores that neither Delaware law, nor OCC's By-laws, nor any other OCC governing document requires recusal of interested directors where directors on both sides of a question have potential conflicts of interest that are fully disclosed to the Board. Nor is there any basis for finding that any such governance issue would invalidate the Capital Plan.

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[34] SIG Comment Letter, at 1 (Feb. 27, 2015).

Several Petitioners have argued that the Board "failed to maintain the requisite number of public directors on its Board" as required by OCC's By-Laws.[35] This argument suggests that the Board was disabled from taking action merely because recently-created Board positions were unfilled at the time the Board voted on the Capital Plan. OCC was specifically advised by outside governance counsel, however, that the vacancies at issue did not prevent the Board from approving the Capital Plan, provided that the proposed rulemaking received the necessary vote of the directors "then in office."[36]

Finally, Petitioners have argued that the Capital Plan is fatally flawed because OCC did not provide notice to the Non-Shareholder Exchanges. This argument fails, however, for several reasons. As an initial matter, Petitioners fail to demonstrate the relevance of this argument at this stage of the Commission's review; even if OCC were found to have violated its own By-Laws by not notifying the non-Stockholder Exchanges of the Capital Plan before it was presented to the Board for voting, Petitioners offer no authority to suggest that the effect would be to invalidate the result of the Capital Plan vote. Further, this argument entirely fails to take account of the fact that the Capital Plan does not impose any material competitive consequence requiring the non-Stockholder Exchanges to be notified.[37] As explained below, the Capital Plan was not competitively significant—specifically, it imposes no undue burden on competition.

B. The Capital Plan Provides for the Equitable Allocation of Reasonable Dues, Fees, and Other Charges Among Its Participants

Under the Exchange Act, the rules of a clearing agency must "provide for the equitable allocation of reasonable dues, fees, and other charges among its participants."[38] In the Approval

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[35] *See, e.g.*, BATS Petition, at 18.
[36] OCC By-Laws, Article XI, Section 1.
[37] OCC By-Laws, Article VIIB, Section 1.
[38] 15 U.S.C. § 78q-1(b)(3)(D).

Order, the Staff correctly determined that this requirement is satisfied by OCC's Capital Plan.

Specifically, as noted in the Approval Order, the Capital Plan's Fee Policy provides for a Business Risk Buffer "designed to ensure that fees will be sufficient to cover projected operating expenses," and Refund and Dividend Policies that "both allow for refunds of fees or payment of dividends, respectively, only to the extent that the distribution of which would allow OCC to maintain shareholders' equity at the Target Capital Requirement."[39] Indeed, the additional capital cushion provided through the Capital Plan will allow OCC to operate safely with a smaller business risk buffer margin than it has in the past, giving clearing members the benefit of a lower fee structure. As correctly observed by the Commission when it declined to object to the advance notice filing:

> The reduction in buffer margin from OCC's 10-year average of 31% to 25% reflects OCC's commitment to operating as an industry utility and ensuring that market participants benefit as much as possible from OCC's operational efficiencies in the future. This reduction will permit OCC to charge lower fees to market participants rather than maximize refunds to clearing members and dividend distributions to Stockholder Exchanges.[40]

Questions have also been raised as to whether future fee changes may result in an inequitable allocation. In addition to being speculative, this concern was properly rejected by the Staff in the Approval Order, where the Staff concluded that the Capital Plan is consistent with the Exchange Act, observing that future changes to Capital Plan's fee schedule, Fee Policy, Refund Policy, and Dividend Policy would require OCC to submit appropriate regulatory filings, provide an opportunity for public comment, and would involve Commission review.[41]

For the foregoing reasons, the Capital Plan is consistent with the Exchange Act's requirement to equitably allocate reasonable dues, fees, and other charges among participants.

[39] Approval Order, at 42.
[40] Notice of No Objection, at 9.
[41] Approval Order, at 41-42.

C. *The Capital Plan Does Not Impose an Undue Burden on Competition*

The Exchange Act also provides that the rules of a clearing agency must "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act]."[42] In considering whether an action is necessary or appropriate, "the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[43] Here, the Capital Plan does not impose an undue competitive burden, and it has both the design and effect of advancing efficiency, competition, and capital generation.[44] As a result, the Commission and Staff correctly concluded that the Capital Plan does not impose any burden on competition.

Petitioners have criticized a perceived "competitive burden on non-equity owner exchanges."[45] No such competitive burden exists, however. Petitioners have not contested that the Capital Plan does not disadvantage or favor any particular clearing member relative to other clearing members.[46] Instead, Petitioners have argued that the Capital Plan unfairly advantages the Stockholder Exchanges over non-Stockholder Exchanges. Specifically, it is asserted that because "dividends may be used by Stockholder Exchanges to offset operating costs and subsidize the cost of execution services they provide to their members, the Stockholder Exchanges will have a competitive advantage over non-Stockholder Exchanges."[47]

The argument is misplaced. First, the Petitioners ignore the Stockholder Exchanges' weighted average cost of capital for the capital they are contributing in the first instance and

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[42] 15 U.S.C. § 78q-1(b)(3)(I); *see also id.* § 78w(a)(2) (Commission "shall not adopt any such rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the [Exchange Act].").

[43] *Id.* § 78c(f).

[44] The Approval Order expressly stated, "In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation." Approval Order at 47, n.115.

[45] BATS Comment Letter, at 2 (Feb. 19, 2015).

[46] *See id.*

[47] MIAX Comment Letter, at 2 (Feb. 24, 2015).

stand ready to contribute under the Replenishment Capital Commitment. Further, Petitioners mistakenly argue that the dividend would enable the Stockholder Exchanges to reduce their fees by 7%-22%, as opposed to the 1-1½% estimated by OCC.[48] Petitioners' analysis is flawed because it artificially inflates the apparent effect of the dividend by assuming that the dividend will be devoted exclusively to subsidizing a segment of the products listed by the Stockholder Exchanges, namely equity options, that corresponds to the Petitioners' narrow business interests. As a result, the Petitioners exaggerate the impact of the dividend.

A simpler and more straightforward way of viewing the dividend is to compute the dividend rate per contract side traded on the Stockholder Exchanges. Even assuming a dividend of $30 million, which is at the high end of what OCC estimates for the next ten years, the dividend rate per contract side for equity options for each of the Stockholder Exchanges would be 0.00290 for NASDQ, 0.00346 for CBOE, 0.00495 for ISE, and 0.00666 for ICE/NYSE. In other words, even if the Stockholder Exchanges were to use the dividend exclusively to subsidize only their equity option products, it would be less than one cent per contract side. Additionally, if the volume of all products of each of the Stockholder Exchanges were considered, the amount available from the dividend for a subsidy would be even less for each of these exchanges. More fundamentally, these amounts are themselves overstated because they do not include the weighted average cost of capital.

In addition, the premise that the dividend will be used exclusively to subsidize fees is unfounded. The Stockholder Exchanges (as well as the non-Stockholder Exchanges) have pricing power from a multitude of sources, including access fees, exchange services, market data fees, and other revenue, all of which have far more impact than the dividend on their ability to

[48] *See* Response of BATS, BOX, and MIAX to Motion of the OCC to Lift Automatic Stay, File No. SR-OCC-2015-02, at 8 (Apr. 8, 2015).

compete. Indeed, the revenue per contract variation among exchanges and among products, which Petitioners themselves note, suggests that the Stockholder Exchanges are not competing on the basis of price alone.[49] Petitioners also fail to address alternative pricing power strategies by which the Stockholder Exchanges could otherwise use the capital they are contributing to OCC to compete on price. In other words, Petitioners' analysis is based on the obviously false assumption that the Stockholder Exchanges would not use the funds that they have committed to invest in OCC in any productive way.

Petitioners have also argued that the dividend is excessive, and have characterized it as in the range of 17 to 30%. Petitioner SIG has offered a table to show that under OCC's assumptions, the dividend is excessive. This table incorrectly ignores the time value of money in its display of rates of return, however, and inaccurately portrays the incremental increase in book value of OCC, which the Stockholder Exchanges cannot access or otherwise use competitively, as part of the rate of return.[50] SIG's argument for including the increase in book value is wholly speculative, in that SIG speculates that if OCC takes on additional investors in the future, the Stockholder Exchanges would monetize the value of the capital reserve account. This speculative future possibility is not a valid basis for finding an undue burden on competition that should lead the Commission to reverse the Approval Order.

SIG has also asserted that OCC's projection of a long-term average annual increase in expenses of 2.3% is inconsistent with OCC's past statements regarding a 9% increase between 2012 and 2013, and a projected greater increase in 2014.[51] This argument should be rejected because it relies on a false comparison between near-term increases and long-term projections.

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[49] *Id.* at 8 n.15.
[50] SIG Opposition to OCC's Motion to Lift the Automatic Stay, File No. SR-OCC-2015-02, at 20 (Apr. 9, 2015).
[51] *Id.* at 18.

Recent increases have been caused largely by the cost of meeting increased regulatory demands that are not likely to recur on an ongoing basis. It is not reasonable to project these extraordinary recent increases over an extended period of time.

Petitioners make much of the argument that the Capital Plan is inefficient from a tax perspective, as OCC will pay taxes on net income not refunded but rather paid out as dividends.[52] The Board, however, considered an alternative requiring nearly $593 million in pre-tax clearing fee revenues to accumulate $364 million in after-tax net equity, but concluded that the Capital Plan was superior, particularly when coupled with the benefits associated with the increased predictability of OCC's ability to comply in a timely manner with existing and proposed standards.

In any event, with respect to the core issue raised by Petitioners—the size of the dividend—SIG has estimated the 2015 dividend rate at 15.69%. Assuming for the sake of argument that this estimate is accurate, this rate of return would not be excessive in view of the Stockholder Exchanges' initial $150 million capital contributions, future required incremental contributions to capital, the Replenishment Capital Commitment of up to $200 million, investment risks inherent in making the capital contributions and Replenishment Capital Commitment, and weighted average cost of capital and internal hurdle rates. The Stockholder Exchanges' ongoing commitments under the Capital Plan go far beyond the commitments typically associated with an equity investment. Furthermore, the projected rate of return for the dividend was considered reasonable by OCC's Board in its approval of the Capital Plan, after having considered the other approaches available to OCC to raise capital, including in particular an approach by which capital is accumulated by increasing clearing fees and suspending refunds.

[52] *See, e.g.*, SIG Petition, at 15 n.26.

For these reasons, the size of the dividend does not impose any burden on competition, much less the undue burden that Petitioners claim.

Similarly, the Capital Plan does not result in unfair discrimination against the non-Stockholder Exchanges. Petitioners fail to appreciate that under the Capital Plan, the obligations of the Stockholder Exchanges and non-Stockholder Exchanges are not identical. Specifically, the Capital Plan secures the $150 million capital contribution and the Replenishment Capital Commitment from the former, while the latter have no such obligations. This Replenishment Capital Commitment is a crucial part of the overall capital resources provided by the Capital Plan, and is of profound importance. Further, contrary to Petitioners' assertions that the Stockholder Exchanges' capital contributions are a "risk-free investment,"[53] the funded and unfunded capital commitments of the Stockholder Exchanges under the Capital Plan in fact involve a substantial amount of risk. Such risks include the inherent risk of a $150 million equity investment, the unusual nature of the investment in OCC as an industry utility, the Stockholder Exchanges' cost of capital, the adverse financial circumstances under which the $200 million Replenishment Capital Commitment would be required to be funded, and the limited "upside" to the investment based on the interaction of the Fee, Refund, and Dividend Policies.[54] In arguing that the economic circumstances requiring OCC to utilize the Replenishment Capital Commitment are unlikely to occur and that the Capital Plan is unnecessary as a result,[55] the Petitioners entirely miss the point: the Capital Plan is designed to ensure that OCC is positioned to address seriously adverse business conditions, even those that

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[53] BATS, BOX, KCG, MIAX, and SIG Memorandum in Further Support of Motion to Reinstitute Automatic Stay, File No. SR-OCC-2015-02, at 2 (Sept. 25, 2015).
[54] *See* OCC Comment Letter, at 3 (Feb. 23, 2015).
[55] *See* Belvedere Trading, CTC Trading Group, IMC Financial Markets, Integral Derivatives, SIG, Wolverine Trading Comment Letter, at 8 (Feb. 20, 2015).

Petitioners believe are unlikely. The Board has determined that the Stockholder Exchanges should receive only what the Board, with the assistance of its financial advisors and in the exercise of its business judgment, has deemed to be fair and in the best interests of OCC given the nature of the investment and the risks inherent in the funded and unfunded capital commitments of the Stockholder Exchanges as described above. The Stockholder Exchanges are making anything but "risk-free" investments, and it is reasonable and appropriate that they be positioned to achieve a fair rate of return relative to other uses of capital.

Petitioners' complaint that the non-Stockholder Exchanges will not receive dividends under the Capital Plan as will the Stockholder Exchanges, while factually accurate, fails to admit a key reality: that the non-Stockholder Exchanges will not contribute any equity capital whatsoever, nor are they subject to the substantial risk of the Replenishment Capital Commitment. Indeed, Petitioners would have the Commission believe that the Capital Plan does little more than "allow the OCC to funnel wealth to the Shareholder Exchanges while harming the options industry as a whole."[56] This position wholly fails to recognize that the dividends are fair remuneration for the substantial capital contribution, limited "upside," and future risks that would be shouldered by the Stockholder Exchanges as a result of the Capital Plan—to none of which the non-Stockholder Exchanges would be contributing. Far from being "excessive subsid[ies]"[57] or tools of the Stockholder Exchanges "to subsidize their trading costs,"[58] dividends under the Capital Plan are not paid at the expense of clearing members and customers, but rather are provided to the Stockholder Exchanges for substituting their capital for that of clearing members and customers. Any argument that the non-Stockholder Exchanges are

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[56] BOX Petition, at 7-8.
[57] MIAX Petition, at 7.
[58] BOX Petition, at 15.

competitively burdened because they will not receive the same dividends as the Stockholder Exchanges is without merit and should be rejected.

Finally, in issuing the Approval Order, the Staff expressly found that,

> [E]ven if OCC's Capital Plan may result in some burden on competition, such a burden is necessary and appropriate in furtherance [of] the purposes of the Act given the importance of OCC's ongoing operations to the U.S. options market and the role of the Capital Plan in assuring its ability to facilitate the clearance and settlement of securities transactions in a wide range of market conditions.[59]

In other words, even if the Capital Plan imposed some competitive burden (which it does not), its terms and structure are critical to OCC's functions and renders it "consistent with OCC's obligations under Section 17A(b)(3)(I) of the Act."[60] Petitioners' argument that the Capital Plan unfairly discriminates against non-Stockholder Exchanges is ill-founded and premised on a fundamental mischaracterization of the Capital Plan's dividends and their function. The Commission should reject these arguments.

D. The Capital Plan Serves the Public Interest

Finally, the Commission should affirm the Approval Order because the Capital Plan serves a compelling public interest. As OCC has consistently shown here and in previous submissions to the Staff and the Commission, the benefits of the Capital Plan are many. OCC will be positioned to provide clearing services on an ongoing basis within essentially the same structure that has well served the markets since their inception—all without the need to radically change the structure to address potential demands of outside equity investors. The Capital Plan strengthens the capital base and, by extension, the financial system as a whole. As already explained, the Stockholder Exchanges, by putting their capital at risk, support market stability and, by extension, the public interest. Moreover, OCC is cognizant of its role as a stabilizer of

[59] Approval Order, at 45.
[60] *Id.*; *see supra* n.44.

the domestic and global financial markets, and the Capital Plan is necessary to support this function.

Further, the Capital Plan will lower clearing fees for all market participants, and clearing members and customers alike will benefit from the Capital Plan because it allows OCC to continue to provide clearing services at low cost. In fact, under the Capital Plan, the capital infusion from the Stockholder Exchanges enables OCC to provide a significant refund of 2014 fees, and to reduce its current clearing fees significantly based on the Business Risk Buffer of 25%. Finally, a well-supported capital base allows OCC to fulfill its role as a SIFMU and be prepared for unpredictable economic events. There is clearly a significant public interest in these benefits of OCC's well-designed and equitable Capital Plan, which the Staff has already reviewed and approved, and to which the Commission has previously issued a notice of no objection.

OCC's Board also considered many alternatives and correctly determined that the Capital Plan was financially superior to accumulating capital through fees, which would have required nearly $593 million in pre-tax clearing fees in order to grow $364 million in after-tax net equity. Recognizing the Capital Plan's myriad advantages, including the increased certainty of OCC's ability to comply with existing and proposed standards, the Board appropriately exercised its business judgment to approve the Capital Plan. Petitioners have provided no valid basis to overturn that business judgment, which resulted in a Capital Plan that is fully consistent with the Exchange Act and that serves the public interest in a strong OCC.

Finally, Petitioners have disregarded the significant advantage to the trading public of including the Replenishment Capital Commitment in OCC's capital resources, which would be lost if the Capital Plan were not approved. Petitioners have suggested that OCC could make up

for the loss of this commitment by increasing fees if additional capital were needed. But this statement disregards the potential need for OCC in a crisis to have a need for immediate liquidity, which can be achieved with the Replenishment Capital Commitment, but not with an increase in fees going forward. Petitioners thus have failed to refute the significant benefit to OCC, and the trading community it serves, of the Replenishment Capital Commitment, which would disappear if the Capital Plan were not approved.

IV. Conclusion

The Capital Plan is consistent with the Exchange Act, critical to OCC's abilities to meet its regulatory obligations as a SIFMU, and necessary to ensure that OCC remains poised to address unpredictable business losses. For the reasons stated herein, the Capital Plan is necessary to the financial integrity of OCC as a SIFMU. It does not impose an undue burden on competition and it equitably allocates reasonable dues, fees, and charges among its participants. Most importantly, it facilitates OCC's important role as a stabilizer of the national and global financial markets. Petitioners' criticisms addressed herein are based upon misunderstandings of the Capital Plan and unsupported predictions and estimates about its consequences, all fueled by the elevation of self-interest above the public interest. It is up to the Commission, however, to ensure that the public interest predominates over the individual self-interests of Petitioners. Finally, any undue delay in approving of the Capital Plan will jeopardize it and its important goals. The Stockholder Exchanges understandably cannot permit their substantial capital contribution of $150 million to languish if there continues to be uncertainty as to the approval of the Capital Plan. The financial markets and investing public also cannot be indefinitely subject to the unpredictability resulting from its delayed implementation. OCC respectfully requests that the Commission promptly affirm the Approval Order.

THE OPTIONS CLEARING CORPORATION

By: *William J. Nissen*

William J. Nissen
Steve Sexton
Kristen Rau
Sidley Austin LLP
One South Dearborn Street
Chicago, IL 60603
Telephone: 312-853-7000

Dated: October 7, 2015

CERTIFICATE OF SERVICE

I, William J. Nissen, counsel to The Options Clearing Corporation, hereby certify that on October 7, 2015, I served copies of the attached OCC's Written Statement in Support of Approval Order by way of facsimile at the numbers shown below and by Federal Express to the addresses shown below, including the original and three copies by Federal Express to the Secretary:

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F. Street N.E.
Washington, D.C. 20549-1090
Facsimile: 202-772-9324

John A. McCarthy
General Counsel
KCG Holdings, Inc.
545 Washington Boulevard
Jersey City, NJ 07310
Facsimile: 201-557-8024

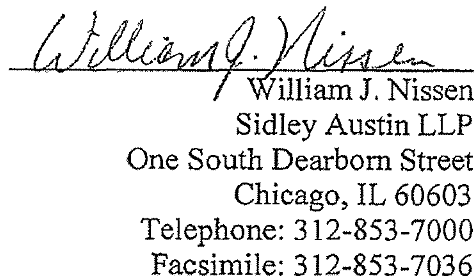
Lisa J. Fall
President
BOX Options Exchange LLC
101 Arch Street, Suite 610
Boston, MA 02110
Facsimile: 617-235-2253

Barbara J. Comly
Executive Vice President, General Counsel & Corporate Secretary
MIAX
7 Roszel Road, Suite 5-A
Princeton, NJ 08540
Facsimile: 609-987-2201

Joseph C. Lombard
James P. Dombach
Murphy & McGonigle, P.C.
555 13th Street N.W.
Suite 410
Washington, DC 20004
Facsimile: 202-661-7053

Eric Swanson
General Counsel & Secretary
BATS Global Markets, Inc.
8050 Marshall Drive, Suite 120
Lenexa, KS 66124
Facsimile: 913-815-7119

Dated: October 7, 2015



William J. Nissen
Sidley Austin LLP
One South Dearborn Street
Chicago, IL 60603
Telephone: 312-853-7000
Facsimile: 312-853-7036